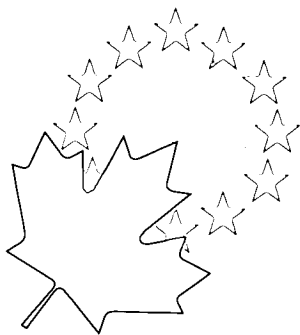


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1992 Implications of a Single European Market

Executive Summary

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**CANADA
EUROPE**

Part I
Effects on Europe

IMPLICATIONS OF A SINGLE EUROPEAN MARKET: EFFECTS ON EUROPE

JUN 27 1989

INTRODUCTION

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The European Community has embarked on a long process toward the complete liberalization of its internal market. By 1992, it is expected that most, if not all, internal barriers to the free movement of goods, people, capital and services among the twelve Member States of the Community will be eliminated. The driving force behind the ambitious project is a shared European goal of global competitive strength for European industry, by taking advantage of a single unified market of over 325 million consumers.

The idea of a Single Market is not new in the Community. The 1957 Treaty of Rome, which established the European Community, provided the legal basis for all the measures proposed in the 1985 White Paper on Completing the Internal Market. The White Paper proposed about 300 measures that would need to be passed in order to achieve the complete liberalization of the internal European market. In 1986, the European Single Act was passed by Member States in the European Parliament. This gave the European Commission the authority to implement the pieces of legislation which would ultimately lead to the creation of the Single Market by 1992.

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For Canada, this development presents major opportunities and challenges. If they meet the 1992 target date, the twelve members of the EC will create the largest trading unit in the world with a GDP equal to that of the United States. The EC accounts for one fifth of global trade. The EC ranks as Canada's second largest export market. It is the most important overseas source of foreign investment, R&D and tourism. Any change in Europe's trading rules will have an impact on Canada; not only on Canadian exports to Europe and to third countries, but also, as European competition sharpens, in Canada's domestic market.

Clearly it is important that Canadians must begin to prepare now for 1992 in order to respond to the challenges, to take advantage of the opportunities, and to adapt to change.

The Government of Canada is in the process of assessing what the Single Market means for Canada and its economy. To this end the Canadian Government has developed a comprehensive strategy called "1992 Challenge".

This program has three objectives:

- o The first is to develop an accurate assessment of the implications of the Single Market for Canada.

Interdepartmental working groups have already been set up to look at how the Single Market legislation could affect different sectors. An ongoing dialogue has been established with the provinces and the business sector to identify and analyze the likely impacts of the European Single Market on the Canadian economy.

- o The second objective is to facilitate the awareness of the opportunities and challenges flowing from the completion of the Single Market.

This study is the first in a series aimed at helping Canadian firms assess the implications of 1992.

- o The third element is to develop an appropriate and effective response to capitalize on the 1992 opportunities.

The Canadian Government's response to 1992 will largely be built on a comprehensive framework of trade and investment promotional activities, and science and technology cooperation initiatives aimed at supporting the business community in its efforts to capitalize on 1992 opportunities. The program will include sectorally focussed trade promotion, joint ventures and technology transfer activities, investment development, and training programs for new exporters to the EC.

EXECUTIVE SUMMARY

PURPOSE OF THIS REPORT

This report is the first in a series that will examine the implications of the EC Single Market for Canadians.

This particular report deals with the "Effects on Europe". The Report consists of two parts. One part outlines the main legislative changes that are taking place in Europe that will affect the policies of European governments and the framework for doing business in the EC. The other part is based on a survey of 425 executives of large European, North American and Japanese firms active in the EC. This survey was conducted by Business International especially for this Report.

This Executive Summary highlights the main findings contained in the Report. It also includes a special section which identifies a number of broad considerations that Canadian businessmen should consider in defining their future strategies (both offensive and defensive) with respect to the new Europe.

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MAIN FINDINGS

A. EFFECTS ON EUROPEAN LEGISLATION

External Trade

Although the EC maintains that it will be the most open trading power in the world, even after 1992, repeated EC calls for reciprocity in market access and for preserving the balance of advantages in the GATT have raised concerns to the contrary. However, as yet, there has been no concrete evidence of increased protectionism by the Community in the manufacturing or service industries - apart from aggressive EC use of the anti-dumping weapon.

One of the EC priorities for 1992 is a common import policy. This will be required to prevent Member States from introducing de facto illegal measures in an attempt to protect sectors no longer shielded by regulations. The Community's various trade policy instruments - the safeguard clause, the "new commercial policy instrument" on unfair trade practices, and particularly anti-dumping rules - will take on much more importance in the future. New target countries and products will be identified, as well as the applications of these rules to the services sector.

There will be an increased focus on local content and rules of origin. It is likely that definitions will be refined in order to define rules of origin as the place where "the most substantial process" rather than where the "last substantial process" occurred.

As 1992 approaches, the six EFTA countries will move as close as possible to EC membership. However, the EC will not entertain any new applications for membership until 1992 and it is unlikely that EFTA will be allowed to develop de facto membership as a bloc.

Foreign Investment

Foreign investment will continue to be welcome in Europe, especially operations that make a clear contribution to the economic wealth of the area and include either significant employment or transfer of technology. EC Member States will become stricter and more selective about investment incentives.

By 1992 it is likely that the GATT principle of national treatment will be extended to services companies set up in the EC.

To encourage trans-European companies, the European Commission has started drafting a new text for the European Company statute. The Community is also pushing toward harmonization of various aspects of company law, so that firms compete on equal terms. A key proposal in this area is a directive covering takeover bids.

Intellectual Property

In 1989 two major developments could occur with respect to a new framework of intellectual property protection in the EC. These would be the adoption of the European Trademark Regulation and activation of the Community Patent Convention.

The Commission is considering extending the power to impound and destroy counterfeit goods that infringe on trademarks, to include copyrights. This would also protect software programs.

Biotechnology is one area where the Community is striving for specific legislation due to the increased reluctance of biotechnology firms to invest in the EC under existing rules.

Product Approvals and Technical Standards

An important part of the Single Market program is the measures that the Community is taking towards mutual recognition of market authorizations in all product areas. To this end, product approval procedures are becoming much more transparent and subject to clear and objective criteria. The goal is to ensure that other European firms benefit from the same treatment as national firms.

Instead of attempting to draft detailed EC-wide standards, the "new approach" to standards and technical regulations now involves the development of broad framework directives limited to essential minimum requirements regarding public health and safety, and environmental or consumer protection. These framework directives are then fleshed out into technical specifications. This is left either to national standards bodies or, where common European standards are necessary, to the Brussels-based CEN and CENELEC.

The other key element in the new approach is the principle of mutual recognition i.e. the acceptance by all Member States of products lawfully and fairly manufactured and sold in any other Member State. This principle was developed by the European Court of Justice, notably in the landmark 1979 ruling on "Cassis de Dijon".

The Single Market program also involves the development of European standards in both telecoms and information technology.

Government Procurement

Government procurement contracts in the EC are equivalent to about 15% of Community GDP.

Although liberalization in public procurement has clear political backing within the Community, existing EC directives covering public works and public supply contracts have had little success, to date, in opening up these markets. Therefore in 1988 the Council of Ministers strengthened the rules, by increasing the transparency of tendering procedures via longer notification procedures and increased publication requirements.

Future EC priority will be given to opening up tendering procedures in telecoms, water, energy and transport.

EC countries will also be moving slowly toward common defence procurement policies through NATO's Independent European Program Group, reinforced by the Single European Act which brings defence into the domain of EC political cooperation.

Technology Development Programs

Community technology programs are becoming more significant. They not only serve to develop the research or technology itself, but also seek to co-ordinate national R&D.

There are a multitude of EC research and development programs. The key ones in the industrial sector are ESPRIT for information technology, RACE for telecoms, BRITE for manufacturing technologies, and EURAM for advanced materials. These programs fund pre-competitive collaborative research. In contrast, EUREKA is the major program for trans-European development projects.

Finance, Banking and Insurance Services

Liberalization of markets for financial services becomes feasible now that agreement has been reached on the removal of remaining exchange controls on capital movements.

In banking and financial services the Commission has proposed the introduction of a single licence valid throughout the entire Community via the principle of mutual recognition.

In time, progress in the financial and banking sectors could affect moves towards a European central bank and a common currency. However, this is not part of the 1992 agenda.

In the insurance sector, there will be a clear distinction between regulations governing large corporate customers and those for individuals. For example with respect to non-life insurance, EC firms will be free to compete across the Community for the business of large corporate clients.

Other Legislation

A number of measures under the Single Market program are directly related to environmental concerns. Among these are directives requiring environmental impact assessments for major investment projects, setting timetables for gradual reduction of gaseous emissions from large combustion plants and motor vehicles, and civil liability for environmental damage incorporating the "polluter pays" principle, irrespective of negligence.

Other significant policy changes that are dealt with in the Report, but not included in this summary, are changes in the areas of competition policy, state aids, regional development, labour legislation, and taxation.

B. EFFECTS OF EUROPEAN FIRMS

The observations in this section are based on a special survey of 425 manufacturing and services firms active in the EC. The sample consisted of 123 EC-based firms; 56 EFTA based firms; 164 North American-based firms; and 14 Japanese firms.

Structural Changes

The Single Market program will quicken the pace and shape the direction of the structural changes already underway in European industry. These include:

- o increased concentration of industry structures;
- o acceleration of national and cross-border mergers and acquisitions;
- o proliferation of cross-border alliances in R&D, production and marketing;

- o focus on core businesses;
- o rationalization of production facilities on a European scale.

One factor behind this prospective shakeout is the fact that in many sectors, Europe's fragmented markets now support many more firms that can co-exist comfortably in the post-1992 competitive arena. For example there are 13 locomotive builders in Europe, compared with 2 in the US and 3 or 4 in Japan. Similarly, Europe has about 40 suppliers of car batteries versus four in the US; and 11 manufacturers of public telephone exchanges compared with four in North America. In a few sectors, such as automobiles, where there are already 6 major European groups, the overcrowding is getting worse as Japanese competitors add capacity in Europe.

In the survey of executives in Europe, which was conducted for the present study, about 85% of all manufacturing and service firms indicated that the 1992 program would encourage a moderate or strong shakeout of competitors in their sector. The competitive shakeout is most strongly expected in food, mechanical engineering and pharmaceuticals, with the lowest scoring in the automotive sector.

Most executives surveyed expect that the restructuring that takes place in their sector will consist of rationalization to achieve cost-cutting. However in some sectors, such as telecommunications, the impact is expected to be more specialized production.

The forces behind restructuring will vary from sector to sector, depending on the industry's characteristics. For example:

- o Producers of commodity products, such as basic chemicals, pulp and paper, metals and minerals and energy, are capital-intensive and, compete on the basis of low-cost production and an ability to consistently provide good standard quality output. The Single Market will mean that some firms will have to expand production while others concentrate on specific product lines.
- o Producers of branded consumer products, such as cars and food products, rely on a strong marketing strategy, with heavy investment in international advertising to support local distribution and service. More international alliances or major takeovers are expected, as are strategies to buy market share, build international brands and establish large automated production facilities.

- o Custom manufacturers (auto parts, specialized machinery and equipment) require close R&D cooperation with their clientele, often close physical proximity, as well as high quality and servicing. Mergers and collaborative agreements of all kinds (including arrangements with local universities and research centres) will be pursued, especially in high-tech fields.
- o Wholesale and retail distribution is dependent on appropriate locations and knowledge of consumer demand, and as such, still regionally oriented. Although there are questions about the logic of cross-border concentration, there are an increasing number of successful examples. Expansion is a means of increasing buying power, leading to bigger discounts and higher profitability.
- o In the financial services area increasing competition between banks and near banks (including insurance companies) coupled with growing integration of capital markets will produce major changes. Some niche players and some major groups will finally survive. The changes, however, will be slow.
- o In high-technology industries (ie research intensive and technology based) the driving force behind concentration is the search for critical mass to support escalating R&D costs. This implies the need for the broadest possible market base - certainly one larger than that provided by Europe's individual national markets. Since many high-tech sectors - telecommunications, power generation, defense electronics - have been dominated to date by national champions insulated from competition, massive restructuring is inevitable, and indeed already underway.

Mergers and Acquisitions/Corporate Alliances

The restructuring process will often take the form of mergers and acquisitions, joint ventures and other forms of corporate alliances. Survey results show that 30% of the manufacturing firms and 56% of the services companies predicted that increased merger and acquisition activity would take place in their sectors as a result of the 1992 program. The percentages were even higher when firms were asked about their own company plans.

Of the three basic acquisition strategies - horizontal, vertical, or diversification - firms surveyed overwhelmingly favoured the first strategy. Vertical integration strategies are relatively uncommon except in telecoms, metals and chemicals.

Diversification goals were found to be significant for auto firms, chemical companies and building material suppliers. In financial and business services no one merger and acquisition goal prevailed.

A striking feature of the survey results is the overwhelming predominance of cross-border (intra European) merger and acquisition plans over purely national deals.

The advent of the Single Market has also triggered an explosion of cross-border corporate alliances. The survey results show that interest in alliances is as great as for mergers and acquisitions, and in the case of the auto sector and Electronic Data Processing (EDP) even greater. These alliances can take a number of forms, from equity joint ventures or cross-shareholdings to contractual relationships. The cooperation may range from R&D and equipment sourcing to joint production and cross-marketing.

Research and Technology Management

The role of R&D as a competitive factor was stressed frequently in the survey, by large and small firms alike. Nearly 40% of manufacturers indicated that they planned to increase R&D spending as a percentage of sales, and nearly 50% cited the need to reduce product development times. Mechanical engineering firms put the greatest stress on both these objectives, while several other sectors such as autos, electrical/electronics, EDP, pharmaceuticals and telecoms, put high emphasis on faster product innovation.

High technology firms in the EC stress the importance of spreading R&D costs over a broader market base. The lack of such a base is cited as a key competitive handicap against US and Japanese rivals.

R&D collaboration is seen by many as a way to achieve critical mass in the research function. Over 40% of the EC and EFTA firms surveyed expect to participate in joint R&D projects under EUREKA, ESPRIT, RACE, etc.

The survey also indicated that the proportion of firms planning to emphasize licensing or buying technology was nearly as great as those planning to increase R&D spending. In fact in a number of sectors it was higher, particularly in the building materials and pharmaceutical sectors.

Investment Strategies

Investment strategies in the EC vary significantly among the different types of firms surveyed.

For example while almost half of EC-based firms indicated they would focus their investments in other EC markets, more than half planned also to expand investments in North America and offshore markets.

EFTA-based firms are building up their presence within the Community. They give relatively high ratings in their investment plans to local production in the EC and to acquisitions, and alliances with EC firms. They also are building capacity at home to increase exports to the EC.

For US-based multinational firms, 1992 has given Europe a higher priority in their investment plans. The result is that direct investment by US multinationals in Europe is growing again, mainly through reinvested profits.

Japanese and Korean companies, faced with ongoing barriers against their exports, have concluded that the only way to secure access to the post-1992 EC market is through investment in the EC. Japanese direct investment in the first half of 1988/89 was up 25% from a year earlier.

Marketing Strategies

Whatever their nationality or sector, manufacturers responding to the survey cited marketing and distribution as the aspects of business that will be most affected by the Single Market program. For service companies, marketing again topped the list.

A fundamental issue is the extent to which the Single Market will smooth out national differences within Europe. Looking at the implications of 1992 in terms of market changes in their sector, some executives expect a strong trend towards the emergence of a homogeneous "Euro-consumer". The homogenizers are especially dominant in energy, metals, autos, electrical/electronics and insurance. However, others give greater weight to continuing differentiation between national markets. The expectation of continued differentiation prevails strongly in building materials, distribution, EDP, banking and consumer goods.

Segmentation is the key to the marketing strategy of the majority of manufacturing and service firms surveyed. The general trend is to focus on market niches - most often at the pan-European rather than national level - although the latter prevails in construction and financial services.

There are mixed views on the extent to which national wholesalers and retailers will be extending their operations across the EC market. The small sample of distribution firms surveyed was split evenly between those aiming at pan-European and those focusing on national market niches.

The Single Market will create strong pressure for coordinating marketing and stream-lining physical distribution. More than half the manufacturing firms surveyed planned to tighten control of marketing and service operations, with the strongest emphasis in the automotive, EDP and metals sectors.

Logistics is another area that will undergo major changes as a result of 1992. A third of all industrial companies surveyed indicated that they planned to centralize physical distribution, with the highest response coming from metals and minerals firms. A major focus of attention is deciding where to centralize production and warehouse locations.

The objectives of efforts to overhaul distribution systems, whether through computerization or centralized warehousing, are to reduce costs and speed up deliveries. Overall, 38 percent of the manufacturing firms surveyed planned to use computer networks to track selling patterns; 43 percent aimed to reduce inventories in the distribution system; and 64 percent hoped to reduce delivery times and improve responsiveness to customers.

Import and Export Patterns

Sixty-nine percent of manufacturers surveyed predicted that the 1992 program would have a moderate to strong impact on the growth of intra-EC trade. Growth in intra-EC trade is generally expected to be stronger than competition from non-EC imports, but in three sector (automotive, electrical/electronics and metals) the increases in EC and non-EC imports are rated equally.

On the export side, nearly two-thirds of EC companies stressed increased sales to other EC markets, while one-third emphasized exports to the rest of the world.

With respect to purchasing patterns, 36 percent of the manufacturing firms surveyed indicated that their own companies would put a strong emphasis on sourcing from other EC countries. Mechanical engineering stands out with a 68 percent rating while telecoms are at the other extreme with a surprisingly low 9 percent.

The survey reveals a keen interest in reducing in-factory inventory holdings, for example through just-in-time inventory

management, especially in the mechanical engineering, machinery, EDP and auto sectors.

Many executives stressed that their companies would maintain an even handed procurement policy, as between EC and non-EC sources, motivated by strictly commercial or strategic considerations. However, several executives expressed concern over EC policies, such as EC anti-dumping pressures, that could restrict their ability to buy abroad.

A fundamental aim of the 1992 program is to develop European industries that can face their US/Japanese rivals in global competition. The survey supported the impression that EC firms will remain outward looking. Indeed, one of the most striking results of the survey is the high proportion of companies that see Europe simply as part of a global strategy - over 60 percent overall in both manufacturing and services, and over 80 percent in EDP, mechanical engineering and telecoms.

Costs and Competitiveness

Discussion of potential costs savings stemming from the Single Market usually starts with the removal of frontier controls. Commission studies estimate that the cost to firms of customs compliance in intra-EC trade amounts on average to 1.5 percent of the value of shipments. Although relatively small, these costs may be a major consideration where profit margins are low. Moreover, border delays and uncertainties are becoming increasingly problematical as just-in-time management of components supply gains in importance. Wholesale and retail distributors are understandably the most interested in this aspect of the internal market agenda.

For manufacturers, significant cost savings are expected to come from restructuring and lower input costs.

- o Rationalization: To ensure healthy long-term profits, companies will be taking steps to concentrate and specialize production in different plants, close down some facilities, and stream-line their product range. Sectors that expect significant savings from rationalization include metals, machinery, building materials, food and mechanical engineering.
- o Economies of Scale: These are the prime considerations for auto firms, and electronics, food and telecom companies.

- o Access to Cheaper Inputs: This is of particular interest to mechanical engineering and machinery firms.
- o Lower Financing Costs: Lower financing costs are the principal concern for construction firms, but of general interest to all sectors. Many executives expect to benefit from the liberalization of banking services.

IMPLICATIONS FOR CANADIAN BUSINESS

Strategic Considerations

Despite the occasional setback the Single Market program remains on track. Over 40% of the legislation has already been passed. Canadian business should make the working assumption that the 1992 deadline will be met.

The scope of the process of deregulation and reregulation in the EC is so extensive that most Canadian firms will have to seriously reassess their strategies in Europe. The impact of the Single Market will not be confined to the 12 Member States of the EC. The six countries of EFTA are already taking steps to bring some of their legislation in line with that of the EC.

Market Access

The rules of access for exporters and foreign firms to the Single EC market are not yet clear. However, it is significant that in most sectors, the EC-based firms surveyed felt that the primary impact of the 1992 program will lead to an increase in non-EC competition rather than lead to higher EC barriers. The sectoral exceptions were automotive, steel and telecoms.

It is also important to recognize that the Uruguay Round of multilateral trade negotiations will have a significant effect on the evolution of the Single Market. The GATT constitutes a constraint on the shape of the EC's internal market by imposing compliance with international obligations already set out in the General Agreement. The Uruguay Round comprises an additional opportunity for third countries to influence the shape of 1992 through bilateral negotiations with the Community within the MTN context and through improved disciplines in such areas as the GATT code on technical standards; market access negotiations on rules of origin; and government procurement.

Since the MTN is expected to finish before 1992, results achieved in the "new issues" of services, intellectual property and trade-related investment measures are also likely to affect the final shape of Community arrangements.

Sourcing Decisions

As a result of the restructuring now underway, corporate customers in the post-1992 EC are expected to be fewer and bigger. Canadian firms will have to deal with larger EC firms. This includes small firms becoming medium ones.

EC firms plan to adjust their purchasing policies by rationalizing supplier networks, and by concentrating orders to maximize buying power. However, few companies are prepared to go so far as to rely on single-source suppliers.

The increased emphasis on just-in-time production in the EC will lead to new supplier relationships based on close proximity, good communications and compatible information systems (hardware and software). Similarly, the growing sophistication of production techniques, with computer-integrated systems solutions requiring close cooperation with the customer, will encourage a greater regionalization of suppliers.

When it comes to purchasing technology, the overriding concern for EC firms is to get the best technology irrespective of nationality. EC firms show a strong tendency to look outside Europe, and especially to North America, for potential technology licensors.

Government Procurement

Access by Canadian exporters to the liberalized EC government procurement markets will be governed by existing GATT rules and any new agreements negotiated during the Uruguay Round.

However, for Canadian firms producing in the EC, where procurement offers are equivalent, Community preference could be invoked to exclude bids with less than 50% EC content.

Investment Considerations

Non-EC firms, whether from EFTA, North America or Japan, will be putting their emphasis on investing in production facilities within the Single Market rather than supplying it through exports.

Initially, investments generated by the Single Market will gravitate towards those countries and regions with the best infrastructure and skilled workforces. Manufacturing firms have identified France, Germany, Italy, the UK and Spain as their preferred locations for production and export to other EC markets. The pattern holds, too, for firms in the services sector, except that the UK and West Germany enjoy a clear lead in preference.

Marketing and Distribution

For manufacturing firms, pan-European distribution networks will be a key competitive weapon in the post-1992 era, as barriers and costs of transborder shipping come down.

It is also anticipated that there will be fewer distribution levels, since in many cases there will be no need for national distributors.

Many EC firms will be centralizing their physical distribution. In particular, major centres in the Netherlands rate highly in the plans of EC firms. The Netherlands is a strong choice for distribution centres because of its central location, major sea ports and airports, and strong trucking industry.

Technical Barriers

EC manufacturing firms surveyed for this Report rated the removal of technical barriers to intra-EC trade and the creation of common EC standards as the two most positive impacts of the 1992 program. However, only one third expect progress on this front to have been achieved by 1992: most expect significant results no earlier than 1995.

Foreign suppliers, protected by the GATT principle of national treatment, should benefit from the new product approval procedures that are being put in place under the Single Market program.

For non-EC suppliers, mutual recognition implies that a company can make its product conform to the norms of the Member State that suit it best, and then channel all its exports to the EC through that State. This would seem to be an improvement on the present situation whereby authorization must be obtained from each Member State in which the exporter chooses to sell.

Although outside suppliers will be given the same access to national certification procedures as local firms, the EC has signalled that it will only recognize tests and certificates issued by third countries if mutual recognition has been negotiated by Brussels (and not by individual Member States).

Technology Programs

In theory, non-EC owned firms operating in the Community will be welcome to participate in all Community R&D programs as long as they have something special to offer and their research is carried out in laboratories within the EC.

Services

The liberalization of financial services and the free movement of capital are rated highly by firms in the services area (especially banking and finance) as well as manufacturing firms as two very important benefits of the Single Market program.

The free movement of personnel is of top importance to business services - a group that includes accountants, law firms and engineering consultants - whose staff will benefit after 1992 from the mutual recognition of professional qualifications.

Although there should be no legal barriers to non-European services firms that are located in the EC, a de facto preference for European companies will make it a definite asset to be seen to be as "European" as possible.

Increased Competition from European Firms

Almost 60% of EC manufacturing firms surveyed and 45% of services companies felt that the 1992 program would have a moderate to strong effect in terms of strengthening EC firms as competitors in third markets.

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